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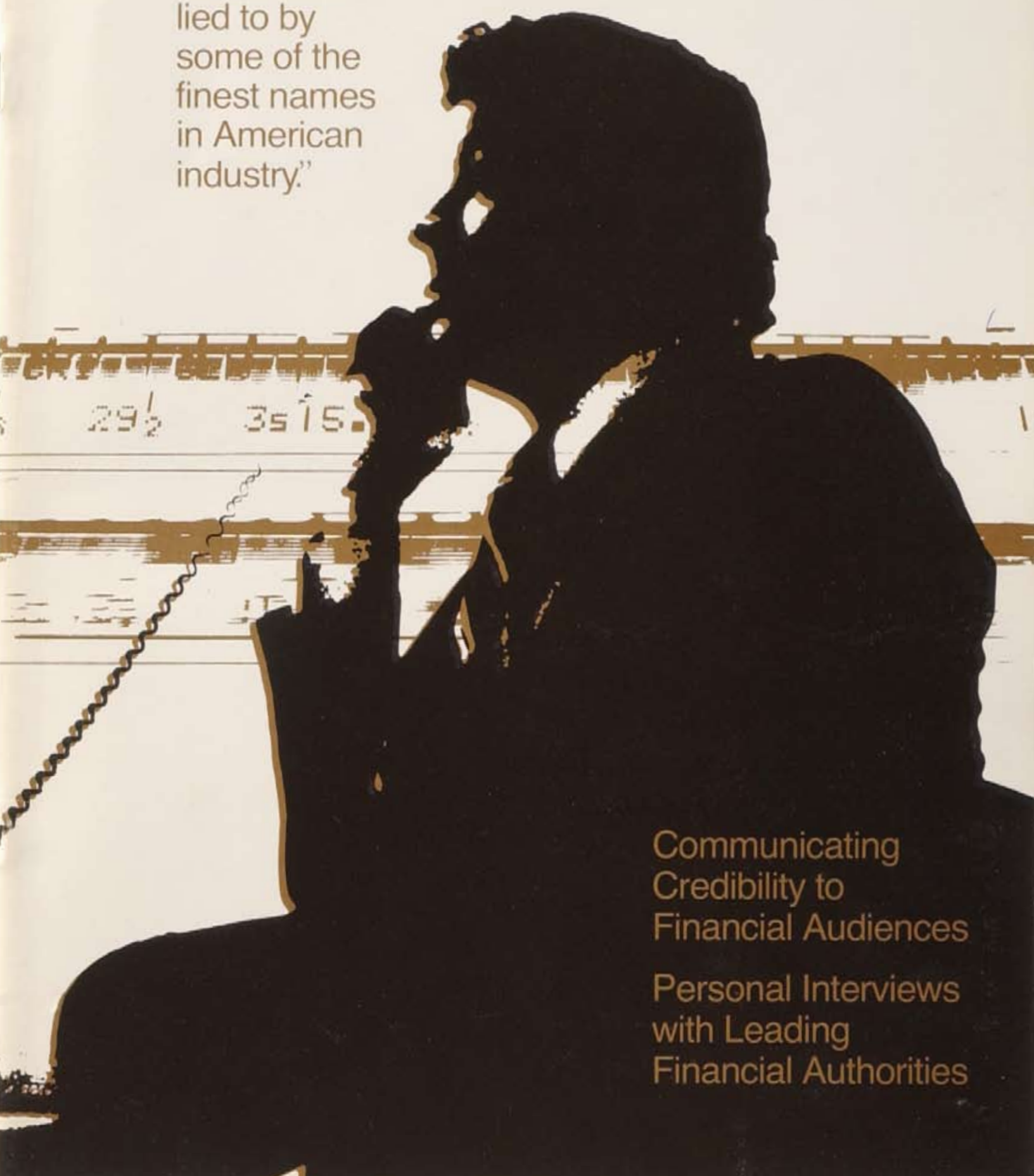
"During my 20 years as an analyst I have been lied to by some of the finest names in American industry."



Communicating Credibility to Financial Audiences

Personal Interviews with Leading Financial Authorities

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A New Dimension in Financial Communications

by Walter P Margulies

For many years we have had the comfortable view of financial public relations as the cement filling the communications gap between corporations and that amorphous entity we refer to as the financial community. This has been done, and sometimes admirably, through the normal communications channels of releases, annual reports, presentations, luncheons, publicity and the like. The problem today, however, is that many in the financial wasteland have simply stopped listening.

And maybe with good reason. If there is one common criticism that could be directed at most financial PR efforts, it is the almost total preoccupation with events of the moment and the complete failure to properly understand and "position" the corporation for the long haul.

Financial communications has now unquestionably become the "front line" for any publicly-held corporation's communications effort, be it large or small. This is one of the reasons why Lippincott & Margulies, known for so long as an innovative leader in corporate communications and marketing design, recently expanded its area of endeavor to include counseling in financial communications. (We have purposely not used the expression "PR", not to disparage this field, but because it is simply not reflective of the additional disciplines needed for this broader area of activity.)

At Lippincott & Margulies, we have given serious thought to the subject of Financial Communications Planning. Some of these thoughts are contained in this document you are about to read. Other ideas are reflected in the financial communications work we are doing on an on-going basis for a number of clients.

In an over-simplified way, it could be stated that the crux of our financial communications philosophy is that before a corporation begins to fill the available communicative channels with a plethora of messages, it must have a clear and keen understanding of its own corporate self—what it is, where it is going and how it plans to get there. At the same time, it must have an unbiased comprehension of how it is viewed by its vital and sometimes diverse financial publics. Only from this basis can a meaningful corporate "position" be established and an effective, long-range financial communications strategy be structured.

To successfully engage in this broadened area of financial communications calls for areas of expertise not normally available to public relations firms and those ad agencies that include PR in their activities. This would include a strong background in corporate identity, substantial experience in the analysis and development of corporate nomenclature systems, financial-oriented research capabilities, experience in comprehending the goals of top management and finally a professional knowledge of both brand and corporate marketing techniques. These disciplines, when added to normal public relations capabilities such as copy, graphics, press contacts and financial acumen, combine to create a corporate communications potential well beyond almost anything being done in the field today.

It is the firm belief of Lippincott & Margulies that the inclusion of additional communicative disciplines into Financial Communications Planning is the inevitable wave of the future. Even now, in work we are doing for a number of corporate clients, the advantages of this unique approach are more than apparent.

We hope the following issue is of some assistance in trying to better understand the complex, changing and multi-tiered entity that is the financial community. As always, we are interested in hearing your comments and reactions.

"...when an uneasy fear arises that perhaps the virus has entered the bloodstream, then the blow to confidence and credibility can be traumatic."

The Climate of Disbelief

"The thing that troubles us most is that we don't know whom or what to believe."

Far from Wall Street, a retired school teacher is responding to a media survey of reaction to the oil shortage. But Senator Robert Dole, a former Republican National Chairman, places this comment in a broader context, calling the public's quandary over what to believe "the greatest domestic problem in the country."

Corporate executives, financial analysts and pollsters are inclined to agree. Frank Harrington, vice president for public responsibilities at INA Corporation, sees an increasingly sophisticated and educated public losing faith in all institutions. He remarks: "Things that used to be sacrosanct like faith in the courts, or a degree from Yale or Harvard, or a clerical collar—are under attack. Our system is not working as well as we would like."

According to pollster Louis Harris, "Confidence in the leaders of financial institutions has fallen since 1966 from 67 to 37 percent...a massive 61 percent of the people in this country generally have real self-doubt about their ability to know where to put their money. Among even experienced investors, a substantial 45 percent express similar doubts." Perhaps even more significantly, "60 percent of all stockholders say that owning securities is a 'luxury' and not a 'necessity'."

The same note was sounded by the Chairman of the New York Stock Exchange, James Needham. In calling for new ground rules on public disclosure, he specifically addressed his recommendations to "the problems of investor confidence in the markets."

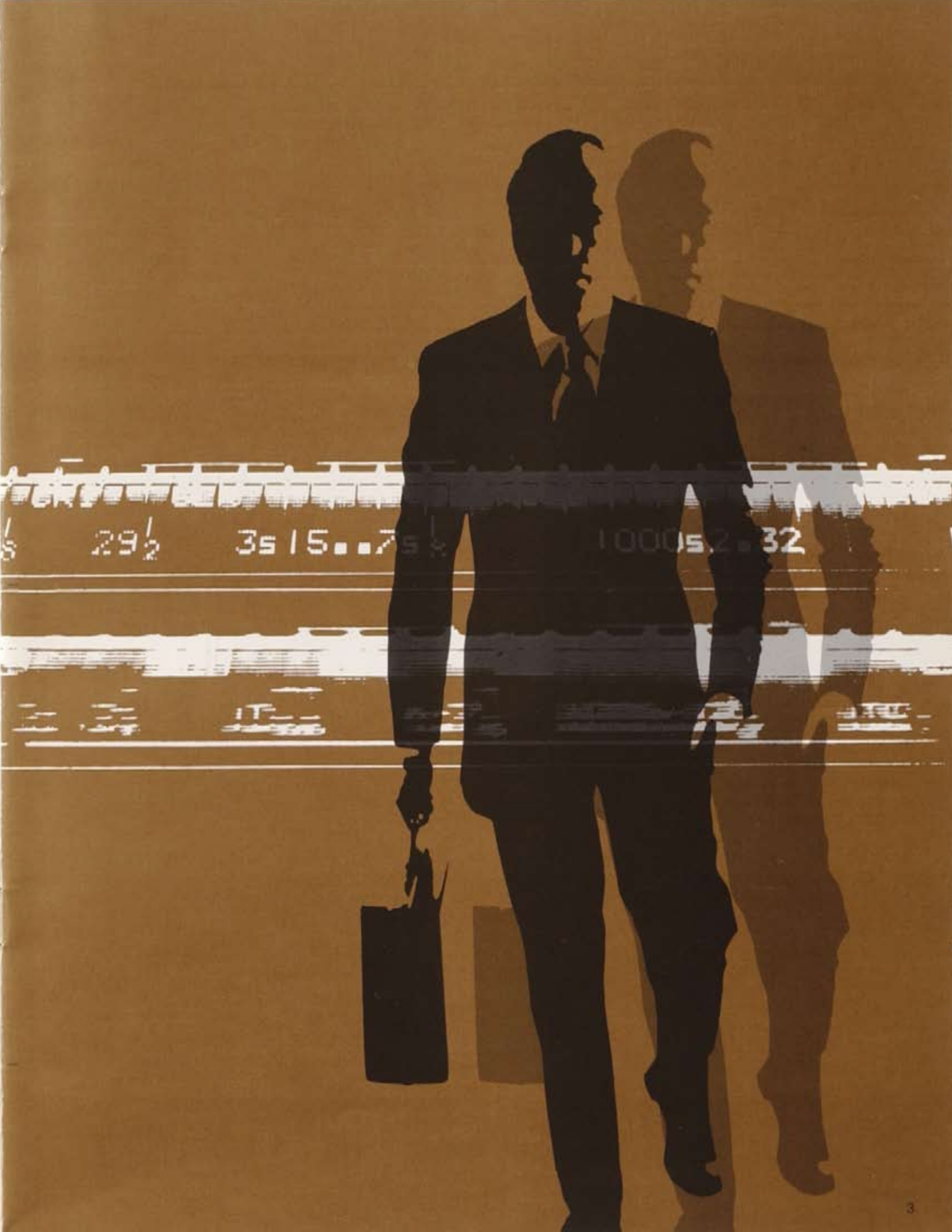
Call it a crisis of belief, a failure of confidence, a widespread and potentially disabling mistrust of big government and big business, there's little doubt that the national mood confronts the corporate community with the kind of underlying credibility problem that will demand far more than cosmetics and good intentions before it is resolved. At stake is not just the health of individual companies but the future of "people's capitalism"—the participation of some 30 million Americans in the growth of the economy through some form of stock ownership.

Nor can the corporate credibility crisis be passed off as a temporary malaise, a mild infection contracted when the business community is suddenly exposed to the virus of scandal emanating from high places in government. At worst, the imputations of wrong-doing in the corridors of power serve to exacerbate a condition that has been festering since the late 1960's, and which, according to some observers, continues in many companies today.

The average stockholder has only to examine his own portfolio to realize that something is askew. The price of National Student Marketing Corporation leaped from $6 to $140 before it collapsed at a cost to investors of over $100 million, leading to the indictment of the corporation's top officers along with a partner in one of the nation's largest and most prestigious accounting firms.

When Equity Funding went public in 1964, its stock sold at $6 a share. By 1969, it had reached $80. Polled at the start of 1972, a group of institutional analysts chose as their favorite stock among hundreds of finance and financial service securities—Equity Funding. On April 5th of that year, after a discharged employee had blown the whistle on the fraud that was being perpetrated, the company filed under Chapter 10 of the Bankruptcy Act, leaving some 100 banks and many of the country's most sophisticated financial institutions stuck with 2 million shares of its stock. Their losses are estimated to be in the $100 million range. Those of the individual investors are probably double.

Nor can the investor be sure he won't again fall victim to the same manipulation or subterfuge. In order to dissociate themselves from the negative effects of exposure, some



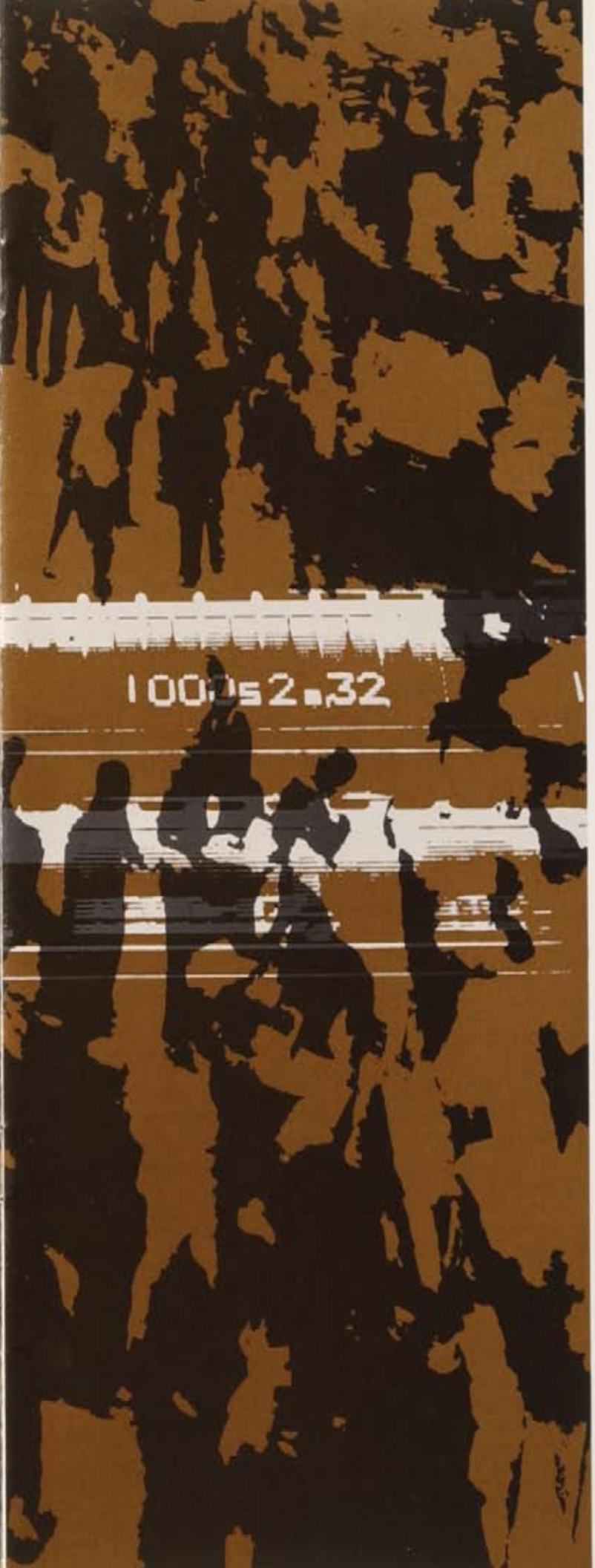
"...even more instrumental in inducing the new mood of disenchantment is the investor's sense...that the gatekeepers of truth and integrity may be failing him..."

companies simply change their names, as when troubled Parvin-Dorman became Recrion or when Leasco changed to Reliance Group.

But it isn't just the indictments and charges of outright fraud that trouble investors. It's possible to emerge battered and bruised and still hopeful from under the collapse of a N.S.M.C., Penn Central, U.S. Financial, Investors Overseas Services, or United States National Bank, provided you view these occurrences as aberrations of the system. But when an uneasy fear arises that perhaps the virus has actually entered the bloodstream, then the blow to confidence and credibility can be traumatic.

Certainly the widely publicized disclosure of fraud in a relatively few companies has brought about a significant and troubling shift in the way the investor perceives the financial community, tilting him away from the forward-looking "will to believe" that characterized the early and mid-Sixties to a prevailing and widespread skepticism. In part the shift can be attributed to an inability to spring back into a recovery mood from one disaster before another strikes. But perhaps even more instrumental in inducing the new mood of disenchantment is the investor's sense that not only have the corporations let him down, but that the gatekeepers of truth and integrity may be failing him as well.

Following the Equity Funding scandal, for instance, insurance stocks generally tumbled 10 to 25 percent because, explained *Business Week's* Wall Street editor, William G. Shepherd, Jr., "many investors decided that independent auditors, state examiners, and the SEC are not reliable protection against fraud." Accountants, who in theory work for shareholders and the investing public, were faulted for abandoning their traditional responsibilities and joining the corporate team—or, as John Brooks phrased it in *The Go-Go Years*, for "thinking legalistically rather than conscientiously." As for belief in what corporations were saying, the results of



one survey revealed that a substantial number of analysts and shareholders believed that corporations *intentionally* designed their annual reports to hide the true facts and confuse the readers.

When the integrity of the financial reporting process is questioned, then the basis on which investors can make rational investment decisions is endangered. Not just one company but many companies suffer when the investor is hit with surprise write-offs, or discovers that information in the 10-K report filed with the SEC differs substantially from that given in the annual report he receives, or finds vital disclosures affecting future earnings concealed in footnotes behind an impenetrable semantic barrier. One company's deceit can be contagious to all, in the mind of the investor.

The Age of Scrutiny

Establishing and maintaining corporate credibility in this skeptical kind of climate is an uphill task. And it's going to get tougher. The spotlight of public attention is being focused relentlessly on questionable (and that doesn't necessarily mean illegal) practices in government, the professions and business, and it's not likely to be diverted until some kind of effective reform is introduced, either through voluntary action or legislation.

The sharper tools being honed by the analysts, the more stringent disclosure practices being recommended by the New York Stock Exchange and the SEC, the "public interest" standards being advanced by the accounting profession, all confirm that the financial community is entering what may be termed the "age of scrutiny," when there will be less tolerance for metaphors for "growth" in the chairman's letter and less room for maneuver in the statistical summaries.

This phenomenon is not limited to the U.S. Indeed, in some ways Great Britain is preparing even broader regulations than those being proposed here. The Company Law Reform

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"...no month passes in the work of a business journalist without his encountering some grotesque and engaging instance of corporate noncommunications with the outside world."

proposed by the former Conservative government in 1973 (and likely to be pursued regardless of who is in power) is based upon the philosophy that "if the system of competitive enterprise is to thrive, it must be open and based upon integrity. If it is not, it will forfeit public confidence and it will fail." Among the provisions being considered are requirements that directors report on the performance of their company in regard to the health and safety of their employees, on the number of consumer complaints received and how they were dealt with, and on the conduct of industrial relations.

Obviously, once the disclosure issue is raised by government in response to public attitudes, there is no telling where it settles, or on whom.

Skepticism Rampant—The Analysts

Credibility, of course, is in the eye of the beholder, and for the publicly held company one of the principal eyes to be concerned with is that of the financial analyst. The reports the analyst delivers on what he sees can raise or lower the price of a company's stock, smooth or make difficult the road to financing, open or shut the door on mergers and acquisitions, turn loyal shareholders into drop-outs or vice versa.

Yet in today's climate of disbelief, the analyst has also been put on the defensive, particularly by the big institutional investors who do two-thirds of all stock market trading. Pension funds, insurance companies, bank trust departments, all question the quality of the information they get from outside analysts and investment advisors and they increasingly retain their own experts. Some money managers charge the analysts with playing follow-the-leader, limiting their analysis to a small range of issues. Others worry that the analysts aren't probing deeply enough, or cease to monitor credibility once it has been established.

Individual investors voice a different complaint, claiming that brokerage houses spend their research dollars exclusively for the benefit of the large institutional customer, while the interests of the retail customer are scanted. They also fault the brokers for mostly urging them to buy, hardly ever to sell.

There's little doubt that the analysts are being asked to do more and that many are vigorously responding. They're still using traditional criteria of corporate credibility: the degree to which a company meets the expectations it sets up; the reliability of its forecasts; how a company looks against the background of its industry; how the stock is held (a plus if it's widely distributed among long-term holders, a minus if it's concentrated among groups out for a quick profit); how management handles the bad news as well as the good.

But they're applying these criteria in different ways, giving them a sharper edge for cutting through obfuscation. Thus one bank maintains computer models of the industries in which it invests—along with models of individual companies within those industries. Any deviation from the norm is immediately signaled, and the margin for surprise is radically diminished.

The common stock department of an insurance company looks to the expertise of industry specialists for analysis, then brings in "devil's advocates"—specialists assigned to other industries—to attack, probe, undermine, and find the weak spots in the analyst's findings. The reasoning: specialization is necessary to get all the facts out to make an evaluation. But questioning by "outsiders" can turn up weak spots that may have been overlooked.

At an investment banking firm, the research director works with analysts to structure management interviews in advance. The latter talk to product managers, salesmen, store clerks, customers, as well as financial officers. Typically, they spend four to five days with one company.

One brokerage firm develops a task force or team approach, sets backroom statisticians to "laboratory-testing" historical data and measuring it against corporate expectations and projections.

"Despite all the emphasis on facts, breakouts, fuller disclosures, corporations in the 'age of scrutiny' will be striving as mightily as ever to build their 'images' as forcefully as ever. And with good reason."

Given the economic realities of Wall Street in the 70's, not all analysts are refining their techniques and consequently not all industries (or companies within industries) will get the same thorough going-over.

Divided Allegiance—The Accountants

But there's one critical area where all companies in all industries are increasingly expected to put their credibility on the line, and that's in the accounting they give of themselves. According to Henry B. Reiling and John L. Burton, writing in the *Harvard Business Review*, the two criteria for financial reporting that analysts most frequently articulate are "(a) adequacy, from the sophisticated investor's standpoint, of the description of the corporation's activities, and (b) the usefulness of the historical data in anticipating the future activities of the enterprise."

Up to now, the onus of "anticipating" has been placed pretty exclusively on the analysts and the "sophisticated investor." Late in 1973, however, the Financial Accounting Standards Board issued a wide-ranging report with 11 recommendations, the most significant of which urged that "financial statements serve the needs of users who rely on such reports as their principal source of information for economic decisions" and provide them "with information for predicting, comparing and evaluating enterprise earning power."

Editorially, the *Wall Street Journal* hailed the report as encouraging evidence that the accounting industry and the SEC are in "considerable harmony in seeking fuller and more meaningful disclosure of the inner workings of corporations and other subjects of audits."

For the nation's 90,000 accountants, the issuance of new principles and standards could signal the way out of a dilemma posed by their public responsibilities and the pressures of the corporations that pay their fees. It can also be seen as part of a broader effort to restore public confidence in the gatekeeper function of the profession.

The Information Factor: More

One thing is certain: the "hard information" factor in credibility is looming over the corporate horizon in an unprecedented fashion. Ground rules which gave companies considerable leeway in using figures to fashion their image are in process of drastic change. The key word in this coming age of scrutiny is "more": more cautious and quizzical analysts, more shareholder-oriented accounting practices, a more open way of corporate life. Not only will corporations be disclosing more, they will be disclosing it to a lot more people.

You can read the trend of change in the new SEC recommendations for greater disclosure. They include: reporting on a company's various business operations; provisions of certified financial statements for the two most recent years; inclusion of a two-year history of the common stock's price range; a two-year dividend history; identification of managment's employment and business affiliations.

The SEC has also adopted amendments to all its disclosure forms which require more comprehensive information on write-downs, write-offs and extraordinary charges, and now requires a company to break out on Form 10-K sales and earnings on products and services that contribute 10 per cent or more to overall business.

And it wants investors to be able to distinguish between recurring and non-recurring revenue and profits, and to get an explanation of any non-operating components of income and any accounting changes that affect earnings, along with a summary of significant accounting practices.

The gap that yawned between earnings reported for taxes and for financial reporting purposes has long stirred controversy. Now the SEC wants companies to disclose the major separate dollar items that make up the difference. It wants the investor to understand why there is a difference between a company's actual income tax and the federal corporate tax rate, and the dollar amount of difference resulting from each underlying cause.

Early in 1974, the SEC began looking into still additional areas which promise change, the most significant of which is probably a requirement that conglomerates and other multiline companies list revenue and profit by specific subsidiaries, rather than broad groupings such as defense business or consumer services.

The SEC is now urging companies to tell stockholders about inventory profits that have resulted from sharply rising prices and the Financial Accounting Standards Board announced that it would study the effects of general price level fluctuations on corporate financial reports.

But according to some corporate executives, more information does not necessarily add up to more enlightment.

"In the near future, the 10-K data will be incorporated in annual reports," comments Theodore H. Silbert, Chairman, Standard Prudential Corporation. "But this will so confuse the average shareholder that corporations will have to devise simplified means of communicating and interpreting the 10-K data in everyday language to their stockholders."

The president of a billion-dollar corporation is even blunter in his assessment of the proposed actions: "I don't believe the efforts being made by the SEC or the Financial Accounting Standards Board are anything more than a great deal of over-kill. Doubtless, some of the regulations will be valuable. Equally doubtless, most of them will be senseless and many will lead to more obfuscation than now exists in financial reporting."

Forecasting—Has Its Time Come?

A former chairman of the SEC once warned that "corporations, to maintain their credibility and security values, will have to be increasingly innovative in the methods used to convey their economic reality to investors."

"Innovative" is probably the mildest word the financial community has applied to the SEC proposal that companies be required to make and publish their own earnings estimates.

"The pressure on management to 'have something to say' is perhaps greatest of all in the direct confrontation with the analysts at luncheons, meetings and seminars."

"Controversial," "necessary," "impossible" are the terms most frequently heard in Wall Street and in corporate boardrooms.

There's good reason for the mixed and intense reaction. Public forecasting goes to the heart of the credibility issue. While practically all the other SEC recommendations for change are addressed to fuller and more comprehensible disclosure of "the facts as they are," forecasting demands that management crystal-ball "the facts as they may be." No other reporting requirement focuses the spotlight of public attention so relentlessly on the believability of corporations.

Forecasting per se isn't new. British firms have been issuing them voluntarily since the 1930's, mostly in connection with prospectuses announcing new stock issues. And in the U.S., executives provide the equivalent of an informal forecast when they agree that an analyst's figures are "in the ball park." There's not likely to be a well managed company that doesn't make its "for internal use only" estimate, and a few publicly announce what they expect earnings to be several months in advance. What the SEC is suggesting is something else, however. The company making a forecast will have to file a form with the Commission explaining in detail the basis for its figures.

Advocates offer several reasons why public forecasting by corporations is desirable. As long as future expectations determine the value of securities, the people best placed to define those expectations, (i.e. management) should report them to existing and prospective stockholders. That means *managements*. Forecasting, its supporters continue, will eliminate the element of surprise. The establishment of formal procedures for determining and publishing earnings estimates would curtail charges that management misleads investors by permitting analysts to circulate inflated earnings estimates.

Professors Henry B. Reiling and John C. Burton declare flatly that "forecasts would improve the nonprofessional's lot substantially, since he is currently unable to wring reliable future expectations from the financial statements."

Just how long-range and detailed are the forecasts likely to be? Security analysts and portfolio managers polled by the Financial Analysts Federation look for predictions a year in advance. Others favor a limited aggregate projection of earnings per share for a few months in the future. Everyone agrees that safeguards are necessary to clearly distinguish forecast from historical data. "If investors are led to believe that, for example, a forecast of earnings per share is as reliable and objective as a statement about per-share earnings last year, grave harm obviously could be done," says one expert.

Opponents, and they would appear to include most corporate financial officers as well as the New York Stock Exchange (which favors forecasting only on a voluntary basis), fear that it would create more problems than it solves. They point to the many factors outside the range of management's crystal ball which nevertheless impinge on earnings.

Says James T. Bolan, president, Kewanee Oil Company: "Who could have predicted the oil embargo? What prophet could have surmised that the government would be so mercurial in its use of Phases II, III, & IV? Can a businessman assess the effect of an inflation controlled by a Federal Reserve system which raises and lowers the level of money in circulation in patterns that are strange and wonderful to behold?"

If forecasts were made mandatory, comments Gustave L. Levy, senior partner of Goldman, Sachs & Co., "People who rely on them and see them go wrong would have a traumatic experience that would lead them to take action that might further dislocate the market."

The question of what happens to a company if it attempts to make an honest estimate and still goes wrong also troubles the legal experts.

According to an attorney testifying before the SEC on the subject, "Problems of liability would be insurmountable unless projections in prospectuses were expressly granted immunity

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"Marshall McLuhan to the contrary, in the corporate world the medium is not the message—but that company is in trouble that does not fashion the right medium for its message."

from prosecution under the law." With several civil damage suits from shareholders already on the horizon, the concern over eventual liability is more than an idle one.

When Management Speaks, Who's Listening?

No matter how wide the spectrum of reporting obligations grows, it's unlikely to replace the initiatives that corporations take on their own to convince the investment community of their credibility. The question is, just how effective are these initiatives? The answer is, unhappily not as well as they could be or should be.

Complains *Fortune* editor Max Ways: "Much of the information emanating from corporations is just hot air...no month passes in the work of a business journalist without his encountering some grotesque and engaging instance of corporate noncommunication with the outside world. He finds public relations departments that are not trusted by their top management with information that ought to be publicized. He finds financial vice presidents who react to questions about the taxes their corporations pay as if the inquiry had been directed to the sex life of their mothers...He finds, above (or beneath) all, the legal counsel of great corporations: some of them could not be more defensive, more evasive, more secretive, if their client were the Mafia."

When asked what he thinks of press releases, a seasoned Wall Street analyst points to his waste basket. Pressed on the point, he concedes, "Well, not all. Some companies really know how to use the press release as an information tool. They only send them out when they have something to say—and they give you the kind of hard data that belongs in your file. After a while, you know which ones to look for, which ones aren't worth a glance. What it comes down to is this: If you have credibility, then you also have readership."

One big factor in credibility is the willingness of management to talk to analysts in bad times as well as good. And while few corporate officers will open a meeting with a run-down on everything that has gone wrong in recent months, more of them are willing to talk openly and frankly about potential negatives.

Again, some companies fare better than others when dealing with groups of security analysts. DuPont, IBM, General Electric, Xerox, to name a few, have "earned" credibility. The analysts still ask searching questions, but they have learned to equate "the facts presented" by these companies as "the facts as they are."

For companies that promised much but failed to meet their expectations, such as Litton Industries or Boise Cascade, the going can be tough. "Once you have lost credibility, it's one hell of a job to regain it," counsels one analyst. "Double-page ad spreads in the financial or business press won't do it, nor will fancy junkets to the home office. What *will* help are facts, and lots of them. It could be an in-depth profile of the company on its way back, maybe a brochure that spelled out breakdowns of earnings and costs by product line, or gave a detailed picture of each division, whatever kind of detailed information which would show (a) that the company was leveling with the financial community, and (b) that it was in control of its own destiny."

Credibility and the Investing Public

Despite all the emphasis on facts, breakouts and fuller disclosure, corporations in the "age of scrutiny" will be striving as mightily as ever to build their "images" as forcefully as ever. And with good reason. For image is the total distillation of a company's response to its public and its environment. It's not just the data it reports, but the motivation that determines how it gives that data to analysts and investors and employees and customers. Marshall McLuhan to the contrary, in the corporate world the medium is not the message—but that company is in trouble that does not fashion the right medium for *its* message.

According to an American Management Association

survey, two out of three industrial companies feel they have serious image problems. Analysts, locating the heart of that problem in corporate communications, see companies failing in two ways: (1) not knowing essential facts about their company, and (2) either not knowing how (or not wanting) to convey those facts to their publics in a way that would build understanding and trust.

It's not that the corporations don't have the opportunities. At one time A & P's annual report was a post card and DuPont issued a pamphlet. Today, annual reports are glossy and expensive affairs that frequently win prizes for visual design—while they turn off the analyst and bewilder the stockholder. Commissioner A. S. Summers, Jr. has even suggested that the SEC "examine" annual reports for "quality and reliability."

If anything, stockholders take an even dimmer view of the corporate communications dilemma. Fifty-three per cent of those surveyed in one report believe that, even if companies tried, they couldn't make their reports comprehensible. This has led to the rather patronizing suggestion that companies issue two reports—one for the "illiterate" stockholder, one for the sophisticated analyst and institutional investor. This is hardly the solution calculated to restore credibility.

Again, it's the analysts who provide the guide to improvement. They look for informative texts rather than flamboyant language. They look for a chairman's letter that addresses the needs and interests of the investment community (and that includes Mr. and Mrs. Smith), instead of rhetorical flights that are brutally grounded by the next quarter's figures. They look for a corporate overview that places divisions and subsidiaries in a meaningful structure—but they also want to measure cost and revenue and potential of the divisions and subsidiaries independently.

One thing is predictable. Reporting in "the age of scrutiny" will demand more communications skills than ever before. Corporations will need to strike a fine balance between what will fulfill the informational requirements of their several audiences—the financial community, shareholders, news media, employees, customers, government agencies—and indulging in the kind of informational overkill that only produces a new kind of obscurity.

Lippincott & Margulies considers this balance as the key to successful financial communications. Consistency is the common denominator. Even without the requisites of SEC reporting, such as eventual inclusion of 10-K material in annual reports, it has been our practice to provide each audience with a continuing dialogue about material developments within the client corporation.

Consistency will foreclose the temptation by management to ignore this year or this quarter as the disappointing result of a decision proclaimed last year to hold great future promise. It also acts as a deterrent to over-estimating the potential of a new venture before its validity has been established.

Conclusion

Is striving for credibility worthwhile? Consider the alternative: a further withdrawal of the average investor from the market, a deterioration in the moral climate that extends beyond the financial community, and a further erosion of a free economy.

According to Sheldon S. Cohen, of the Washington law firm of Cohen and Uretz and former Commissioner of Internal Revenue, "If the 'good guys' don't start acting like credibility was important, we will have an economy in which the government will be taking an even larger part—and that will change our free enterprise system."

John M. McEwan, Senior Vice President, Central National Bank of Cleveland, sums it up this way: "Telling the truth may be painful at times, but the consequences of not doing so are becoming increasingly hazardous to one's corporate health and, perhaps, ultimate existence. The more we focus on corporate ethics and morality, the better off we will be."

Personal Interviews with Leading Financial Authorities

Lawrence R. Wachtel

Lawrence R. Wachtel

Vice President, Bache & Company

How is the two tier market affecting the credibility of companies?

Credibility is not the question as much as recognition. Under the two-tier system the institutional money managers concentrate on a select number of companies out of the vast complement of listed and unlisted stocks. A company can be doing a great job and be extremely communicative and credible, but might simply suffer from lack of recognition, perhaps due to size, capitalization, accessibility, etc. Thus, the change in investor mix over the past 10 years from 70% public—30% institutional to 70% institutional—30% public has resulted in a narrowing scope of recognition and thus a narrowing of market leadership. I don't think the credibility factor has changed.

How does a company up in the bleachers with the 2000 get down into the grandstand with the 200?

They have to have some element of the unique. They have to have credentials such as a provable earnings record, demonstrable control of operations, a product that may be out of the ordinary or a marketing approach (a way of doing business) that is above the norm. And they have to have the ability to chart a course and arrive at the destination point approximately on schedule. If a company has these exceptional qualities, it will be found. Naturally, it helps for a company to be public relations conscious. There are low key ways of gaining recognition such as fact filled reports and corporate profiles. Field trips to institutional seminars are also helpful. But Wall Street looks askance at too much flag-waving. If you are doing your thing, and it is an above average thing, you will be found.

How is financial public relations changing?

Simply put, the analysts have no time for a snow job. They don't want one of those broad presentations that promise much but say little. The financial public relations representative must have the facts and figures at hand to supply the financial analyst. A free lunch and a lot of platitudes is nowheres-ville.

How important is management in communicating with the financial community?

The first thing that counts is the record. The strongest personality and the most engaging personal relationship does not aid the situation when the record is poor. And the shy-retiring management personality is viewed with respect if the record is good. Personal rapport is important of course and the ability to communicate the story of your corporation in lucid fashion is also important. But, the old bottom line invariably enters the picture. Usually, the management interview only confirms preliminary but extensive spadework.

How would you sum up credibility?

Simple enough. You make a projection and it comes to pass. You appraise a market and your appraisal is correct. The companies that lack credibility are the ones where something always seems to go wrong with the projection. There is nothing more credible than a 10-year record of 15% growth per annum in corporate profits. There is nothing more conducive to an absence of credibility than a peak and valley record when the expectation was for ever higher peaks. The proof is in the eating.

Michael Cohen

Research Director, Lehman Brothers

What changes do you see shaping up in the role of the analyst?

There will be fewer middle-range analysts, most of whom engage in reporting, and more of the commission business for research concentrated among "superstar" analysts experienced in in-depth probing. Unfortunately, no research department can afford a "superstar" for every industry, yet there are ample opportunities to train the leading analysts of the future. And, as we enter an era of highly competitive commission rates, the institutions will pay for fewer analysts per industry. The result may be a polarization of research: "superstars" closing the credibility gap with great expertise on a relatively limited number of companies. They will account for the lion's share of the business, while the residue gravitates to the average and above-average analysts. That's not an ideal situation; however, there's little place for conventional "me too" analysis today. To really determine what is going on in corporate affairs, the analyst, for instance, has to examine and evaluate individual products performing among competition, appraise the competition itself, and make meaningful comparisons, dig for inventory evaluations, determine which adjustments are of a non-recurring nature, etc. That kind of research is costly, time consuming and, given the economic realities of the Street today, necessarily selective in application.

What criteria can be used to determine the company's credibility quotient?

Measure what you know against what you are told. This entails massive prior industry and company research, model building where applicable, and careful preparation of interviews. Only with this kind of preparation can the analyst be positioned to identify corporate weaknesses, gaps, and inconsistencies. Notably, he has to consider the role of computer software programs in messaging data and creating unique proprietary research undertakings.

What improvements would you like to see in corporate communications?

Managements should visit each major market in the country and hold presentations which feature identification of the parts that make up the corporate whole. More visual aids and graphics would help in identifying problems and showing what is being done to alleviate difficulties. More plant tours would also be helpful because they illustrate (or negate) a lot of the statements made in the annual reports.

Is it possible to know a company well and still be surprised?

Sometimes you get to know a company so well that you forget what it's really like, particularly if the company is well established. Look what happened at Penn Central. No one really noticed the early managerial difficulties; management was taken for granted and the company was permitted to move into real estate without serious questioning by the Street. Another hazard is heavily relying on a "dependable source of information," someone who always feeds you the facts "straight"—until one day they're not so straight and you're in trouble. Multiple sources of information, lots of prior research and relentless probing—that's the only way to avoid unpleasant surprises. And to accomplish this on a large scale requires more highly trained, experienced analysts with creative talents than there are around today.

Monte J. Gordon

Michael Cohen

Monte J. Gordon

Vice President and Director of Research, Dreyfus Corporation

When did the individual investor start questioning corporate credibility?

The questions started with the advent of the highly speculative market of the late 1960's. Loose accounting practices prevailed and analytical standards deteriorated. There was a disproportionate emphasis on quarterly earnings. Entire companies disappeared in the conglomerate maze. Others "grew" 60 per cent in a period when the economy was moving at a much slower rate. It wasn't too long before the public realized that the atmosphere in which the accountant and analyst were working had ceased to be professional. Cast adrift without moorings, the investor simply withdrew. You still see the effects in the so-called two-tier market. There's a large residue of disbelief that's keeping him out today. He feels that the big institutions are being fed with the best information while he has to scratch on his own. Of course he can go to his broker and get the information he needs. But he's just not as aggressive as the institution in using available resources and he doesn't have the time and the skills to evaluate the information he does get, which is understandable. For the institution, investing is a business. For the average man or woman, it's an avocation.

Would companies help their credibility if they were more forthcoming with bad news?

Honesty is not necessarily its own reward. When things go wrong in a company, and an acquisition or a merger falls through, is it obliged to say it is being hurt by competition in advance of disclosing its earnings? If it's of significance, then the bad news should be announced, because it will affect the company's stock. The analysts certainly want to know about it. But people won't place as much weight on the fact that management "told all" as they will on the fact that something bad happened. They might just say they were stupid to reveal it. But then full disclosure was not designed to garner accolades for a company. It's imposed as an essential ingredient in a free marketplace where investors make decisions on the basis of reliable information. In any case, immediate reactions to both bad and good news are probably excessive. If announced earnings are good, what's important is knowing where the income came from; if they're bad, what went wrong and will it recur?

Edward D. Zinbarg

Vice President, Common Stock Department, Prudential Insurance Company

Is specialization the safest route for analysts and money managers to travel in determining a corporation's credibility?

Institutions have a special responsibility in looking at companies. Smaller institutions and individual investors look at our holdings, for example, and presuming that with our research resources we must have done our homework, may decide to put their dollars into the same stocks. To live up to this kind of responsibility as well as for our own protection, we have gone beyond specialization, which is only part of the job. As the world becomes more complex, it's necessary to look at companies from a multifaceted viewpoint. Take energy, for instance. Specialists couldn't possibly encompass all the forces that impinge on such an industry, so we have developed a team of generalists, with broader horizons, to work with the specialists.

Are there other ways of making the specialists' expertise more effective?

We are giving thought to assigning a "devil's advocate" role to portfolio managers. Thus in addition to a broad overview of all the stocks in his portfolio, one manager might have to keep a particular watch on chemicals. Then when the chemistry specialist comes in with his report, the portfolio manager will ask all the tough questions he can come up with from his generalist viewpoint.

How many companies get this kind of going-over?

Institutions tend to focus on from 200 to 400 companies. We're in the upper range.

How do you gauge the credibility of a company? Do you have any guidelines?

We are very wary of promotion-minded managements. Exposure to management is desirable, but the company that seems super-good at PR arouses our suspicion. We also look cautiously at companies which have a large number of product lines but are not one, two or three in any, and fail to break out their product lines in detail in the financial statements. One company breaks its products down into consumer and industrial —and leaves it at that!

Are personal contacts important?

We personally visit each firm we invest in. Interviewing management, touring facilities, talking to employees and customers—sometimes it's a waste of money, but it's the kind of safeguard we intend to keep. We investigate all stories, no matter how convincingly told. How the corporate financial people react to questions is also important. We get quite upset when we sense that the contact can't answer questions he should be able to. Unless our analysts get all the information they need, there's no investment. Seminars can be important in providing information if they are handled right. General Electric, for example, moves its seminars around from one facility to another. Over the years, analysts who cover the company get to talk to a wide range of plant managers and employees, not just those at headquarters.

Do you favor the SEC proposals for requiring companies to make more detailed disclosures?

Definitely. We want all the information we can get, even news releases. As it is, even Form 10-K information can be abominable. It's a disgrace that more companies don't make their 10-K's available to stockholders on request and promptly.

Robert H. Stovall

Edward D. Zinbarg

Is the time ripe for mandatory forecasting?

It's not an issue on which one can make a judgment at this time. Perhaps the way to explore the issue would be for the SEC to require that *it receive* the forecasts. The SEC could then publish a compendium in which the companies' anonymity would be protected. That way the financial community could see the different ways companies tackled the problem and eventually decide on the advisability of forecasting. There's no way companies could be held accountable for the accuracy of the forecasts, but they could be held responsible for using the forecast to mislead the investor. A major problem would be specifying a format that would fit all kinds of companies.

Robert H. Stovall

Vice President and Director of Investment Policy
Reynolds Securities Inc.

How important is management in establishing corporate credibility?

During my 20 years as an analyst I have been lied to by some of the finest names in American industry. You ask all the probing questions and check the answers against data from the corporation's competition and industry data. Basically, an analyst tends to believe the Chairman's statement if he concludes that a recession is bottoming out of his particular business. Often enough to be an occupational hazard, it has happened that two months later you discover them taking further write-offs, cutting or eliminating dividends. All managements know an analyst will print some of what they say—and still they mislead you. The reason is, many corporate officers just can't stand to face the facts about their companies. They tell you what they would like to happen, and hope, despite all evidence to the contrary, that it will happen. Mostly, you can identify and discount the outright fabrications. More troubling is the officer who just can't judge the state of his own company or the environment in which he is operating. This happened frequently in the heyday of the conglomerates, when some managements failed to understand the companies they acquired and unintentionally gave misleading information.

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